

## INFORMAL STAFF ADVISORY OPINION 02-4

This advisory opinion addresses the preparation of financial statements under the FTC's Franchise Rule. In its request, the California Department of Corporations asks whether franchisors are required to prepare financial statements according to Generally Accepted Accounting Principles of the United States ("American GAAP"), or whether franchisors may prepare financial statements using foreign standards, such as Canadian GAAP, if they can demonstrate that such standards are in conformance with American GAAP?"

### I. INTRODUCTION

We begin with the text of the Franchise Rule itself. Section 20(i) provides that financial statements "are required to have been examined in accordance with generally accepted auditing standards by an independent certified or licensed public accountant." 16 C.F.R. § 436.(a)(20)(i).

In the Final Interpretive Guides to the Rule, the Commission elaborated on the preparation of financial statements as follows:

These financial statements must be accompanied by an opinion from an independent certified or licensed public accountant that the statements have been examined in accordance with generally accepted auditing standards of the United States. . . . An "independent or licensed public accountant" is an accountant who is permitted under the law of such person's State to prepare opinions on audited statements and is independent of the company being examined. Financial statements prepared and filed with the Securities and Exchange Commission in accordance with SEC Regulation S-X and the SEC's Accounting Series Releases may be used, even though their preparation may differ in minor respects from generally accepting accounting principles.

44 Fed. Reg. 49,966, 49,981 (August 24, 1979).

In the Statement of Basis and Purpose accompanying the Rule, the Commission also made clear that "[t]he requirement that the statement be examined in accordance with generally accepted auditing standards includes the requirement that they must be prepared in accordance with [GAAP]." 43 Fed. Reg. 59,614, 59,680 n. 433(December 21, 1978). Sources for GAAP include:

statements and interpretations of the Financial Accounting Standards Board (FASB), and the opinions of its predecessor, the Accounting Principles Board (APB), standards of the Cost Accounting Standards Board (CASB), AICPA [American Institute of Certified Public Accounts] Accounting Research Bulletins (ARB's) and Accounting Series Releases (ASR's) of the Securities and Exchange Commission. Other relevant

authoritative sources include AICPA accounting interpretations, AICPA industry audit and accounting guides, rulings of the United States Supreme Court, rulings of the Secretary of the Treasury, pronouncements of professional associations (e.g. American Accounting Association) and regulatory agencies.

*Id.*

## II. ANALYSIS

Based upon the record, we believe it is clear that the Commission intended that all franchisors must prepare financial statements using American GAAP (both accounting and auditing principles).<sup>1</sup> Indeed, in deciding what will constitute acceptable compliance standards, the Commission will look to the AICPA and American Accounting Association standards, among the other authorities noted above. Nothing in the Rule, Interpretive Guides, or Statement of Basis and Purpose suggests that the Commission contemplated accepting any alternative foreign standards.

We recognize that the marketing of franchises has changed since the Commission has promulgated the Rule, including the growth of sales of foreign franchises in the United States. We are also mindful that application of American GAAP might make it more difficult for foreign-based franchisors to compete in the American market. Nonetheless, we conclude that only American GAAP satisfies the Rule's financial statement disclosure requirements.

In the Statement of Basis and Purpose, the Commission explained the GAAP requirement. Specifically, application of GAAP adds to consistency, conformity, and comparability of financial disclosures:

By requiring the financial statements to be prepared in accordance with GAAP, the Commission has attempted to provide guidance to franchisors as well as protection to prospective franchisees. The standard of GAAP is well established in the accounting profession and business world and is relatively ascertainable. It provides a set of common ground rules for the interpretation of financial data. Thus, instead of leaving the prospective franchisee in the position where he or she must accept financial information as the franchisor disseminates it, the Commission, in requiring those statements to be prepared in accordance with GAAP, provides assurance that they are prepared in accordance with a mutually understood set of ground rules. The use of GAAP brings consistency, conformity, and over time, comparability to financial reporting. While the principles of GAAP may not be evident to unsophisticated franchisees, they will enable

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<sup>1</sup> This is underscored by the requirement that financial statements be prepared by an independent or licensed public accountant "permitted under law of such person's State to prepare opinions on audited statements." 44 Fed. Reg. at 49,981.

franchisees to obtain better advice from professionals who will understand the principles involved.

*Id.*

The same reasoning applies today. In analyzing this issue, our primary concern is to ensure that prospective franchisees receive material information in a form that they can understand and compare. As a preliminary matter, there is no assurance that foreign accounting and auditing standards in general are as rigorous as those in the United States. Further it is unreasonable to expect even sophisticated franchisees to understand accounting and auditing standards adopted in other countries, let alone to be able to compare among financial disclosures prepared under varying standards. Nor is it likely that even professional advisors will be able to understand financial statements prepared according to a variety of standards. In addition, it would be extremely difficult, if not impossible, for law enforcers to determine Rule compliance when franchisors use unfamiliar standards.

### **III. EQUIVALENT ALTERNATIVES**

Finally, we turn to your specific question whether financial statements prepared under foreign standards would be acceptable if demonstrated to be in conformance with American GAAP. We suppose it is possible that a particular country's standards may be the functional equivalent of those in the United States, at least for the limited purpose of preparing franchise financial statements. However, we note that American GAAP may evolve over time, as may a foreign country's standards. Therefore, what may be equivalent may vary from time to time. In light of recent accounting scandals in the United States, for example, we would also expect further revisions of American GAAP to address problems that may be unique to the American market. In addition, we are concerned about presentation. The goal of achieving consistency and comparability would be lost if a foreign country's standards, though identical to those in the United States, are presented in a format that does not permit easy review and comparisons with other franchise systems' financial statements. For these reason, we conclude that only American GAAP is acceptable unless an American independent certified or licensed public accountant will certify that the foreign financial statements both satisfy American GAAP and is presented in the same format as American GAAP.<sup>2</sup>

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<sup>2</sup> While your advisory request is limited to the Franchise Rule, we believe the same approach applies to the Uniform Franchise Offering Circular ("UFOC") Guidelines as well. We have discussed this issue with Dale Cantone, Deputy Attorney General of Maryland and Chair of the North American Securities Administrators Association ("NASAA") Franchise and Business Opportunities Project Group. While NASAA has not taken a position on this issue, Mr. Cantone agrees with our position. Item 21 of the Guidelines states that franchisors must "prepare financial statements in accordance with generally accepted accounting principles. These financial statements must be audited by an independent certified public accountant." In our view, the references to "generally accepted accounting principles" and "independent certified public accountant" suggests

Please be advised that the views expressed in this letter are those of the FTC staff. They have not been reviewed, approved, or adopted by the Commission, and they are not binding upon the Commission. However, they do reflect the opinions of the staff members charged with enforcement of the Franchise Rule.

Date: November 18, 2002

Franchise Rule Staff

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the drafters of the Guidelines contemplated American GAAP only: nothing in UFOC Item 21 would suggest any position to the contrary. Indeed, we believe it was on the basis of American GAAP that the Commission approved the use of the UFOC Guidelines in the early 1990's. Accordingly, any franchisor that uses foreign GAAP in preparing disclosure documents for state law purposes, runs the risk of violating the Franchise Rule.